Audit's® NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

August 8, 1980 VOL. XI, No. 15

INVESTMENT STRATEGY AND SELECTION ISSUE

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MORTGAGE TRUSTS: INVESTMENT STANCE AS INTEREST RATES TOUCH BOTTOM THIS CYCLE

For some time now, we have depicted the mortgage trusts as having prices that fluctuated inversely with the movement of interest rates. As rates rise, prices fall, and as rates fall, prices recover. The mechanism is that the mortgage trusts are perceived essentially as income vehicles, and the market price of the stock would move to adjust the dividend yield to that which could be earned in other non-equity securities and investments.

Now that interest rates appear to have bottomed out, it is appropriate to examine the strengths and weaknesses of the mortgage trusts, so that you can be prepared to play the next cycle. Moreover, since in the eyes of many investors the REIT industry is characterized by the large, institutional REITs, which are still mainly mortgage trusts, it is prudent to attempt to get a handle on those trusts--Northwestern Mutual Mortgage, Equitable Life Mortgage, Wells Fargo Mortgage, and so on--which serve as a proxy for the rest of the REITs, however erroneously.

This concentration on the mortgage trusts goes back to about 1970, a year when REIT public offerings and private placements of equity and debt amounted to over 11% of the total corporate financing in the U.S., as it had the year before. The REITs did not face the dividend restrictions of other financial institutions which were the traditional sources of mortgage funds; ergo, most of the new investment funds of the REITs in the years from 1970 to 1973 were in mortgages, generally construction and development loans.

At the end of the first quarter of 1970, REIT holdings of construction loans amounted to $1.47 billion, or 11% of totol U.S. construction loans outstanding. From there, holdings rose at a 60% compound annual rate, to $9.61 billion in the first quarter of 1974, or 20% of the total U.S. Similarly, REIT land loans amounted to only $362 million in the

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1970 first quarter, 10% of the total U.S., and rose at a 76% compound annual rate to $3.47 billion in the 1974 first quarter, or 28% of the total U.S. Long-term mortgage lending also expanded rapidly in this period, from $524 million in 1970 to $4.3 billion in the 1975 first quarter.

Beginning in 1974, high interest rates and overbuilding led to widespread defaults, and many of the mortgage trusts were in the business of managing foreclosed properties and eventually exploring new lines of business. Most of the institutional trusts escaped the worst effects of the real estate recession, however, with a notable exception being the Chase Manhattan Mortgage trust (only now emerged from bankruptcy and renamed the Triton Group).

Today, there are only about 20 qualified trusts remaining which are still legitimate mortgage trusts, with more than half of their assets in mortgages as opposed to properties. These can be broken down into two groups, the long-term mortgage trusts and the short-term mortgage trusts. It is the specific nature of the different types of loans that determines how the stock price moves in regard to interest rates.

The most popular form of short-term loan remains the construction loan; these are loans with maturities between one and two years which finance (naturally enough) the construction state of a real estate project. It is generally paid off with the proceeds of a long-term mortgage loan when completed. Development loans, or land loans, also a form of short-term mortgage loan, antedate the construction loan. Proceeds are used to prepare a site for ensuing construction. Short-term mortgages can also be given on completed property for which there is no long-term financing.

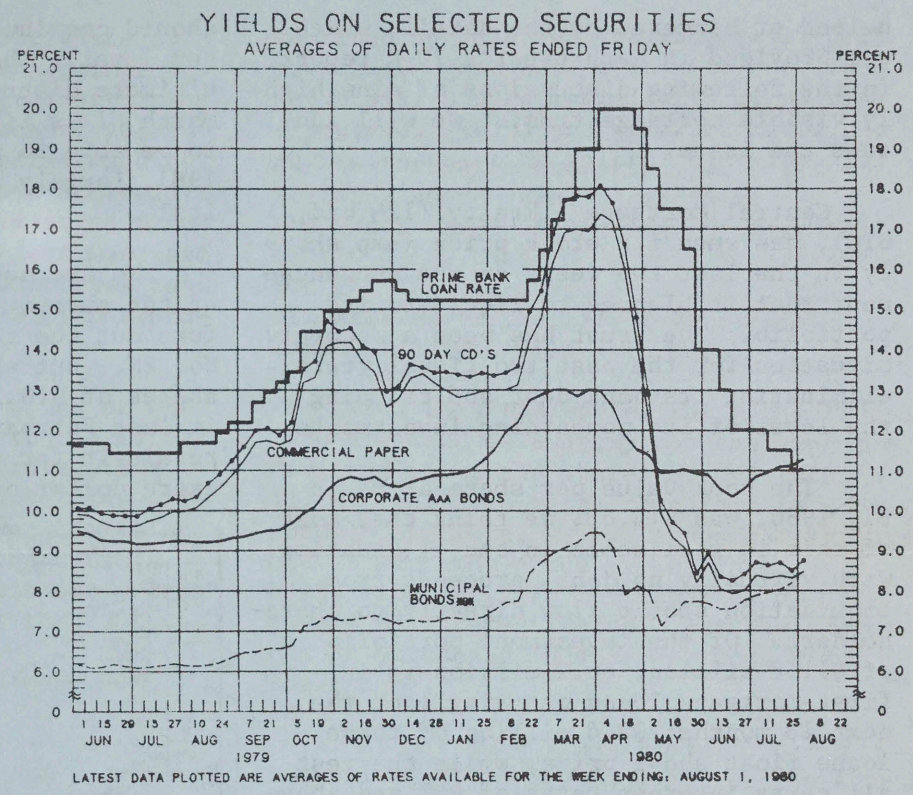
Long-term mortgages have maturities of from 15 to 30 years; the REITs generally make these loans on apartments and on commercial properties. This is now the largest loan asset category for the REITs, generally commitments dating back to the early 1970's.

The final major form of mortgage financing in which the REITs engage is the junior mortgage, in which the interest of the REIT is subordinate to that of another ("first") mortgage loan. A common form of this is the wrap-around mortgage, where the amount of the loan equals the unpaid balance on the first mortgage loan plus additional cash advanced to the owner of the property. The rates charged for these, as for construction and development loans, are higher than for long-term first mortgage loans because of the higher risk involved.

In general, short-term financing is used to support short-term lending and long-term financing to support long-term lending. While the effects of this on stock prices during a period of rapidly rising interest rates are much the same, the reasoning behind the mechanism differs. For the short-term mortgage trusts, the cost of debt is escalating more sharply than the trust can raise rates it charges on its construction or development loans, thus reducing or wiping out the spread between interest earned and interest charged. For the long-term mortgage trusts, while the cost of money is fixed, the low rates on mortgages held means that the realizable market value of the portfolio declines steadily as interest rates rise. In both cases, the price adjusts the dividend yield to that obtainable in other income vehicles, as stated before, since the shares do not represent equity interests whose value can be expected to increase with inflation, nor will the income streams on the portfolio increase to the market rate. Moreover, the short-term mortgage trusts run the additional risk, as their spread is reduced or wiped out, of cutting their dividend, further depressing the stock market price.

There are three major criteria in determining the advisability of investing in the mortgage trusts: expectations regarding interest rates, the possibility of developing mortgage vehicles which are more inflation sensitive, and the maturities of the loans in the various

portfolio. The first two considerations determine whether or not investment in any of the mortgage trusts is proper at a given time; the third helps decide among trusts.



The adjacent graph traces the movement in interest rates over the past year. Rates rose gradually throughout last summer, then climbed sharply in October, when the Federal Reserve announced that it would let the market determine interest rates. After falling back slightly, the rates then plateaued from December until mid-February, when the Fed raised the discount rate to 13% from 12%. Rates then rose steadily until April, when the prime rate reached 20%, the rate on 90 day CD's reached 18%, and the rate on commercial paper reached 17%. Since, we have seen interest rates fall even more rapidly than they had climbed, down to a prime rate of 11% and other short-term rates of between 8% and 9%; in the past couple of days, these rates have begun to edge up, indicating that the bottom had been reached.

Now that the recession looks as if it is slowing, however, a pickup in the demand for loans combined with renewed inflation fears will probably act to boost rates somewhat from their current lows. The length of the recession and the speed of the recovery will be the question here. Alternatively, the amount of money looking to be invested will help keep rates down, but it seems unlikely that rates will go any lower than they are now.

Fears regarding continued high inflation are supported by various new forms of loans which have been proposed, all of which contain inflation hedges, often with some sort of equity kicker being taken in exchange for some short-term interest income. Renegotiable rate mortgages have been discussed from some time, and recently the Equitable Life Assurance came out with a variety of refinements on lending to protect the value of investments from erosion by inflation or fluctuating interest rates. Features include floating interest rates, shorter maturities, principal that floats with the value of the underlying assets, and various equity kickers such as warrants, convertibles, or add-on contingent fees. The value of these is two-fold; the interest rate variants will help maintain spreads and protect the market value of loan portfolios, while the equity kickers will tend to reduce the solely income aspect of the securities. In general, it is doubtful that the mortgage REITs, or any lender, will again be caught with portfolios yielding far below market rates.

The immediate issue becomes that of the time frame for rolling over existing portfolio loans into new investments. Here each trust must be examined individually in a process which is either

helped or hindered by the details which are provided in each trust's 10-K report. In the following discussions of nine highly visible mortgage trusts, we will address the issue.

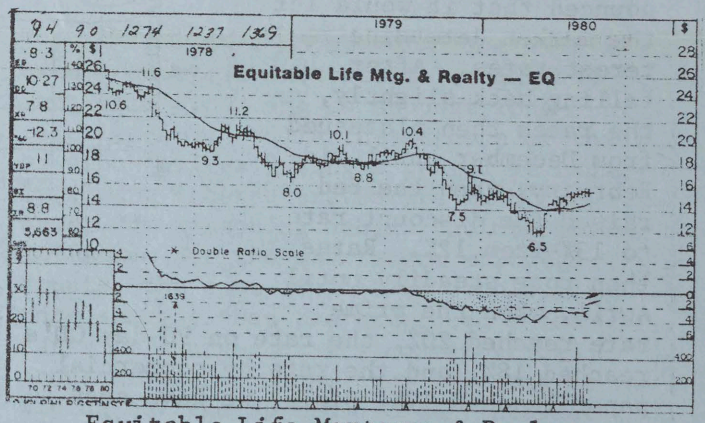
Central Mortgage & Realty (12½ bid, OTC), has seen its stock price jump sharply in the last two weeks on the announcement that it planned to liquidate its portfolio. The trust has been a recovery situation for the past two fiscal years, eliminating its bank debt and reducing the level of its nonearning investments.

The book value per share at March 31, 1980, was $14.63; we think that most of this is realizable in the liquidation. With virtually no debt, proceeds from liquidation should flow directly to shareholders. Of the investment portfolio of $11.8 million, $6.2 million is in first mortgage loans maturing over the next 18 months; $3.4 million of these loans float above prime, while the rest all carry interest rates of 9½% and above. Real estate equities amounted to a gross $1.9 million, in an apartment building and an industrial building in Kansas; these yielded 10.3% cash return on investment in fiscal 1980. Foreclosed properties of $1.8 million included $900 thousand under contract to be sold; other properties include a townhouse project and land. Of the remaining mortgage loans, $1 million float above prime and mature in 1983; a $665,000 loan at 9% also matures in 1983, while a $731,000 loan matures in 1991. A $340,000 demand construction loan at prime plus 5% is delinquent.

The trust earned $1.53/share in fiscal 1980 (March) including 28¢ of sale gains, and 39¢/share in the June quarter with no nonrecurring gains. The trust has omitted its 15¢ quarterly dividend in order to use its $3.37/share taxloss and capture capital gains on its income prior to distribution.

While the trust does not necessarily plan complete liquidation, the early maturity of the bulk of its portfolio points in that direction. Any loss on the sale of foreclosed properties should be offset by interim income (the trust should continue to earn at its June quarter level); therefore we think that an ultimate distribution of book value at March 31 is likely. The trust expects to be able to pay about $6/share by mid-1981, largely a taxfree return of capital.

We are not advising new positions at the current share price, and therefore cut the rank on Central Mortgage to No. 2N. But all those who bought the shares at $10.50, where we recommended it last February, or subsequently, should retain it for the capital gain and the extra dollar or two.



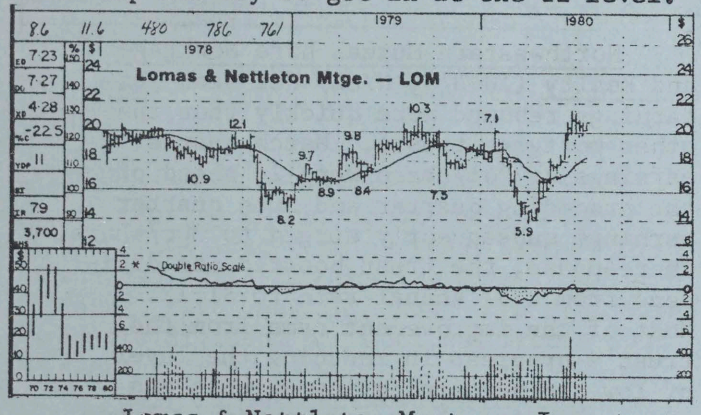
Equitable Life Mortgage & Realty (14-3/4, NYSE) cut its dividend to a $1.40 annual rate from $2 in April, as the spread on its leveraged investments went from .43% at the end of the January quarter to -1.17% at the end of the April quarter. Of $374 million in invested assets, $188 million was in long-term mortgages, $196 million was in short-term mortgages, $36 million in properties and $24 million in foreclosed properties. Some 28% of the portfolio was at floating rates.

Against its portfolio, the trust has $240 million in debt of which $218 million floats with the market. Clearly this was the cause of its difficulties as rates skyrocketed. The stock price fell as low as 11½ before recovering to its present level and a yield of 9.5%.

The reduction in interest rates can be expected to improve Equitable's earnings remarkably (it earned 35¢/share in the April quarter, against 40¢/share in

the preceding quarter and 53¢/share in year-earlier period); but sharp improvement also depends on strong construction activity. The trust has recently been allowing the amount of invested assets to fall as construction loans are paid off. No real kick can be expected from the maturation of its long-term mortgage portfolio, which carries maturities to 2009 at rates from 5½% to 10½%; the process is too drawn out.

The play in Equitable would be the raise of its dividend back to the former $2 rate once its spread improves. But the near-term likelihood that rates will rise from their present level limits attraction, especially with the trust's high exposure. We would wait for prices to dip and try to get in at the 12 level.



Lomas & Nettleton Mortgage Investors (20-5/8, NYSE) has been very sensitive to interest rate swings; its stock price fell sharply in the first quarter of the year and has since climbed even more steeply. Invested assets of $340 million at March 31, 1980 consisted of $303 million in short-term mortgages, mainly construction loan, and the rest in foreclosed property. Against this, the trust carried $240 million in debt, all floating.

Like Equitable, Lomas & Nettleton has been allowing the size of its portfolio to contract as construction loans are paid off; also like Equitable, the trust cut its dividend in May to 55¢, down from 65¢. In its June 30, 1980, fiscal year, the trust paid out 100% of its earnings, or $2.41; final quarter earnings recovered a penny, to 56¢. But unlike Equitable, earnings throughout 1980 remained ahead of the year-earlier level.

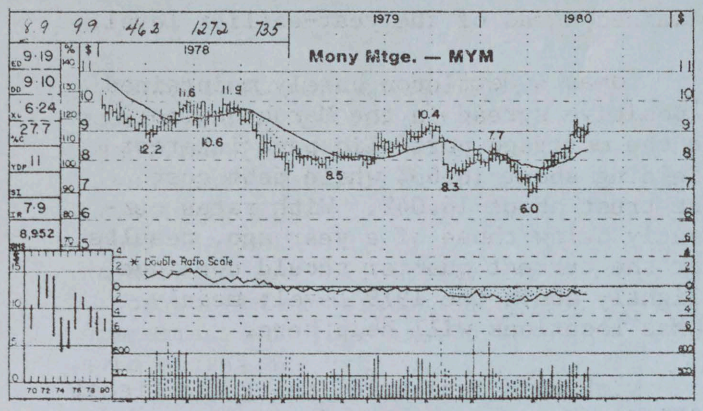
Lomas & Nettleton barely maintained a positive spread in the March quarter, as the mortgage portfolio paid interest yielding about 16.63% while debt cost the trust about 16.04%. With rates currently below those of a year ago, results for the current quarter should continue slightly above the 1979 level; mainly Texas locations will help here.

With this rationale, using the fiscal 1980 dividend as a proxy for the expected dividend rate, the shares are yielding 11.9%. While we think that this is a reasonable estimate, we hesitate to make purchases with the price at its three-year high, especially in anticipation of a recovery of interest rates. But the shares can be purchased on dips as rates rise,, for income.

M&T Mortgage (13-1/8 bid, OTC) is a smaller, Texas-based, construction lender. The investment portfolio of $57 million includes $47 million of short-term mortgage; the trust has bank debt of $40 million, which has somewhat restricted earnings (May quarter earnings of 42¢/share compared with February quarter earnings of 50¢/share), but locations in strong markets has meant that demand for high-rate construction loans held up well. Assets declined only slightly in the May quarter.

M&T shares are selling at a 25% premium to book value, unusual for a mortgage trust, but reflecting high yield for current market of 12.2%. While rate is attractive, risk is potential erosion of share price as rates rise, but shares can be bought for income on dips.

MONY Mortgage Investors (9, NYSE) also has tracked interest rates closely in the past year, but unlike Lomas & Nettleton, remains substantially below highs of 1978 and 1977. MONY's 23¢/share quarterly dividend has not been covered by operating earnings since 1976, so the shares carry a higher perceived market risk than stable earnings and strong management control of problem loans

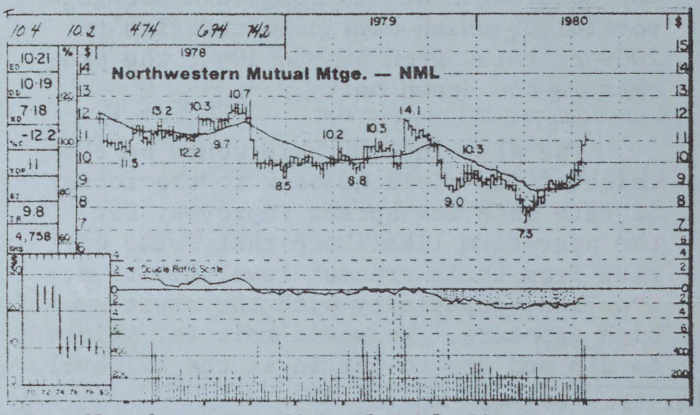


would indicate.

MONY began as a long-term mortgage lender; since 1977, the trust has been emphasizing short-term construction loans. Its portfolio of $206 million contains $90 million in long-term mortgages and $89 million in short-term loans; the balance is in properties. At the end of February, 1980, the short-term loans were yielding 15.3%; the long-term loans bear rates from 8% to 10¼%, and while a majority of the loans contain provisions for contingent interest based on gross income, the liquidation of the portfolio is very far down the line. Maturities extend until 2009, so no impetus to earnings can be expected from the rollover of these mortgages, and they will continue to be a drag on return on book.

Against its portfolio, the trust has $122 million in debt, of which $76 million is interest sensitive. The trust is purchasing its 7% convertible debentures in the market to meet sinking fund payments.

MONY's earnings held up pretty strongly in the latest cycle; May quarter earnings of 19¢/share were only a penny under those of the preceding quarter and ahead of operating earnings in the first two quarters, although down from the year-earlier 23¢. But the dividend remains a question, although near-term earnings should improve on the rate decline; future rate increases would call for more asset sales to support the dividend despite the stated intention of increasing equity interests. MONY tends to sell at less of a discount from book than other mortgage trusts, also a problem since the long-term mortgage loans inflate book from realizable value. While none of the mortgage trusts are recommended for purchase until rates rise somewhat, MONY is a less attractive interest vehicle because of these difficulties.

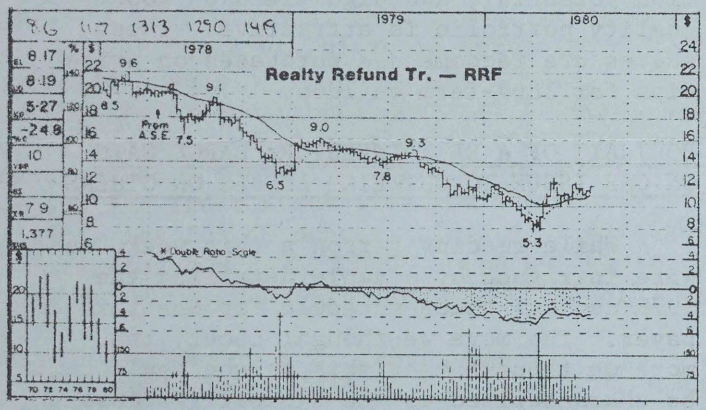


Northwestern Mutual Life Mortgage and Realty (10-3/4, NYSE) has seen its earnings rebound more quickly than the other mortgage trusts. March quarter earnings of 24¢/share were 2¢ ahead of the preceding quarter and June quarter earnings subsequently surged to 30¢/share. In response, the trust boosted its dividend from a $1 annual rate to $1.12. Most of the improvement came from the trust's progress in reducing the level of low and nonearning investments and augmenting its short-term mortgage loan portfolio.

Northwestern began as a long-term mortgage lender; its portfolio of $239 million is still mainly composed of these, with $132 million in long-term mortgages against $64 million in short-term mortgages. Against these the trust has $145 million in debt of which $66 million is floating. This negatively impacts earnings as follows: while the short-term mortgage loans were yielding 16.14% at March 31, 1980, the long-term loans were yielding only 8.89%, for a total return on mortgage loans of 11.2%. All debt, however, was costing the trust 13.2%, although a strong equity base brought the total cost of capital down to 7.6%.

Similarly to MONY, Northwestern has a very long liquidation schedule for its long-term mortgages, which carry rates

from 5% to 10.8% and mature out to 2008. As with MONY, this means that equity investments are going to be delayed as investments are made to retire short-term debt rather than in new equities. But the shares are yielding 10.4% and the current level of earnings should be sustainable even as rates rise somewhat, as problems continue to be worked off. These shares are an attractive income vehicle to be purchased as the price falls on rate increases.

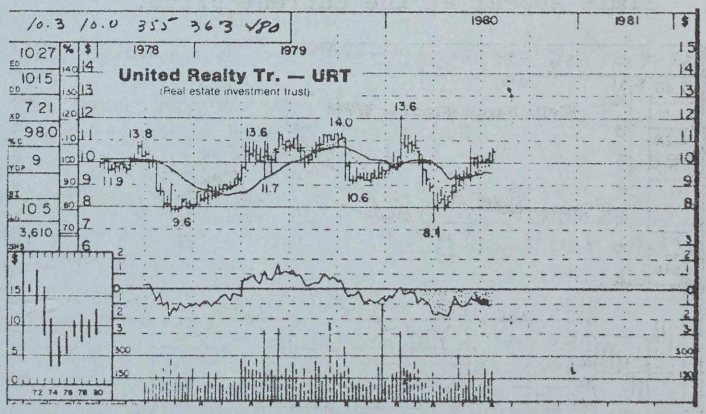


Realty ReFund Trust (10½, NYSE) is a smaller long-term mortgage lender whose shares, while fluctuating with interest rates, have been in a long-term downtrend, as its dividend has declined from a 60¢/share quarter payment early in 1977 to the most recent declaration of 24¢.

Realty ReFund specializes in wrap-around mortgages, on which it profits by the interest spread between the loan which the trust assumes and the mortgage loan to the property owner. The investment portfolio amounts to $70 million in loans, that is, investment in $154 million loans receivable less $85 million of loans underlying wraps. While the trust has avoided defaults since inception in 1971, high vulnerability to interest rate swings have resulted in the erosion of earnings and subsequently of stock price.

The trust moved to cut its exposure in 1978 through issuing two series of debentures, but the sharp climb in interest rates and its effect on remaining bank debt far outweighed the benefits of the new debentures. But with the decline in rates, the 24¢/share earned in the April quarter should prove to be the low.

It is difficult to calculate the current yield on the Realty ReFund shares as the dividend fluctuates with earnings, but giving the worst possible case, annualizing that latest dividend gives a 9.1% yield. If we project that the trust will match its fiscal 1980 performance on the grounds that interest rates are now below those of a year ago, the shares are yielding 12.7%. Now that the shares have fallen back from their recent high of 12½ they are an interesting speculation on eventual restoration of earnings to former peak level, but continued near-term weakness can be expected as rates rise. But 1980 low of 7-5/8 should not be surpassed, limiting some of the downside risk.



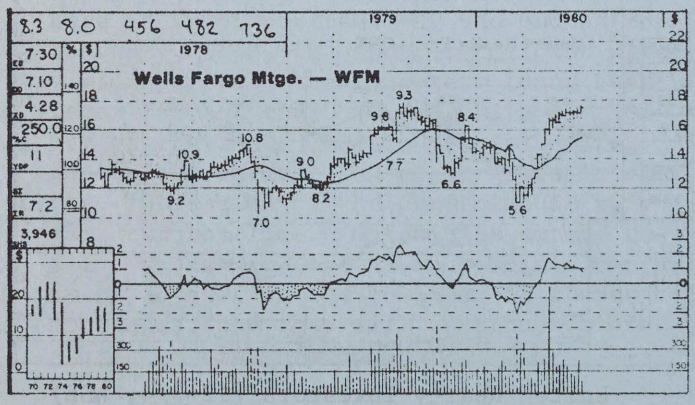
United Realty Investors (12-3/4, ASE) has seen its share price rise sharply to a high for the year in the past few weeks; the shares now yield 8.2%, below the level of the other mortgage trusts.

United began as a long-term mortgage lender; its portfolio of $72 million now comprises $33 million in mortgages, $12 million in GNMA's, $6 million equity investments and $21 million in forclosed property. The trust has only $6 million in debt, most fixed rate.

United now is stressing restoring foreclosed properties to earning status and making new equity/joint venture investments. No new mortgage investments are planned. The bulk of existing mortgages do not mature until the late 1980's and early 1990's, however, so that growth in the near-term will have to be fueled

by continued resolution of problems. The opening of its Ramada Inn motor hotel in Rochester, Minn., which had been closed since foreclosure in September, 1978, should provide a boost. GNMA holdings provide substantial liquidity for new investments.

United earned 26¢/share in the May quarter, which equaled its dividend declaration. Earnings should continue their gradual improvement, to the tune of about a penny a share per quarter, with no rate vulnerability fears. Recent price gains indicate that United is now perceived as an equity play, and not an income vehicle, but we feel that this is somewhat premature, given the long maturity of the portfolio. In the meantime, the lower yield and slower gains in income limit appeal at the current price.



Wells Fargo Mortgage and Equity (19-5/8, NYSE) also has seen sharp price rises helped by a 43% increase in its dividend to a $2/share annual rate, for a current yield of 10.2%. While June quarter operating earnings of 38¢/share lagged behind those of the first three quarters of fiscal 1980, earnings throughout the year were ahead of the year-earlier level. For the full fiscal year, the trust earned $2.10/share, including 48¢ of special items, against $1.93/share, including 66¢ of special items, in fiscal 1979.

The trust's $211 million portfolio is mostly short-term construction loans, amounting to $138 million; the balance is $71 equity investments and $7 million foreclosed properties. Wells Fargo has moved more rapidly than the other trusts to establish a substantial equity position, which helped limit its rate vulnerability in the last cycle. About half of the trust's mortgage loans had floating rates, in addition, still, this was outweighed by $111 million of floating rate debt of total debt of $132 million.

WFM shares continue as interest vehicles because of high proportion of mortgage loans. But equity interests add stability and point to some appreciation potential, and high yield on good quality portfolio is attractive. These shares are recommended purchases on price dips for long-term buildup.

PORTRAIT OF A REIT INVESTOR: LARGE GAIN ON ONE ISSUE TO OUTWEIGH LOSSES ON OTHERS

While reading Barron's this week, we were intrigued by a table detailing the 1979 capital gains schedule for one taxpayer. The more we thought about, the more we thought that this person could be characterized as the typical (successful) REIT investor.

During the year, he sold a total of 11 issues long-term, for a net capital gain of $234,455 on an investment of $720,399. While he did quite well on three bank issues, for a total gain of $82,046, his most striking investments were in three REIT shares. He took a whopping loss in Guardian Mortgage shares, losing $25,359 of his initial investment of $26,373 (the shares were purchased at an average price of $26.37). He took a proportionally smaller loss on his Moraga shares, losing $41,752 of the initial investment of $58,708 (purchased at $19.57 each--if he'd purchased then when we recommended them, at $3, he would have done quite well).

But, his moment of glory far outweighed these minor losses. Having purchased Continental Illinois Properties at $11.54, he tendered his shares at $30, for a gigantic $203,099 gain, by far his largest transaction.

This is what all REIT investors aim for, the large gains far outstripping losses on other shares. The name of this particular investor? Ronald W. Reagan.